Continued Financial Turmoil Clouds Outlook for Austrian Financial Intermediaries

The analysis is largely based on data reported by Austrian financial intermediaries for the first six months of 2008, which means that their structural and risk indicators for that period still reflect the booming business of the past few years. The deepening of the financial turmoil has, however, since led to a marked deterioration of business conditions in financial markets. In this context, we have made an effort to infer likely future scenarios from the data available up to the end of June 2008. Unfortunately, we will not be able to offer firmer conclusions about the impact of the financial turbulence on the Austrian financial market until the data for the second half of 2008 have become available.

In general, the situation of the Austrian banks has remained stable. Their direct exposure to the crisis in the subprime market has been comparatively limited, but the indirect effects of the crisis, especially its repercussions on the economies of Central, Eastern and Southeastern Europe (CESEE), will be more sub-stantial.

Profits of Austrian Banks Shrinking but Still Robust

Solid Asset Growth despite Financial Turmoil

In the first six months of 2008, Austrian banks' unconsolidated total assets continued to rise sharply despite the turbulence in international financial markets: With annual growth of approximately 13.1%, a rate last achieved in 1985, total assets increased to EUR 972.2 billion. As in the previous periods, banks basically benefited from steady growth in their cross-border operations. The five largest Austrian banks[1] accounted for 43.8% of total assets in mid-2008, which represents a slight increase compared with end-2007. At sector level, the two networks of credit cooperatives (Volksbank and Raiffeisen banks) reported the highest annual growth rates (25.4% and 20.9%, respectively). The growth rates of the other sectors were below average, with building and loan associations as well as savings banks reporting the lowest figures. In terms of market shares (based on unconsolidated assets), the joint stock bank sector accounted for the largest market share (close to 28%), followed by the Raiffeisen sector (25.7%) and the savings bank sector (16.0%).

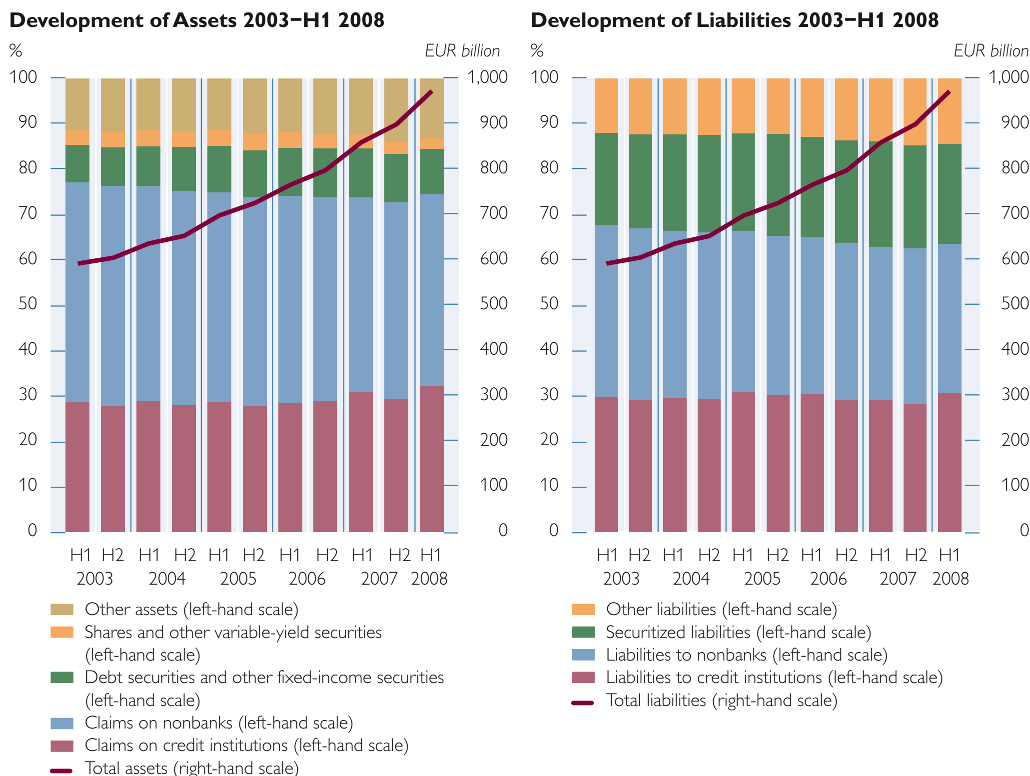
Continued expansion in cross-border business boosted external assets by 14.6% to over EUR 390 billion. This growth was mainly driven by cross-border claims on nonbanks, which jumped 25.2% year on year. The share of cross-border lending thus rose from 39.0% (end-2007) to 40.1% (mid-2008) of banks' assets. On the liabilities side, the external share inched up from 30.4% to 30.6%, reflecting among other things strong growth in foreign liabilities against credit institutions (+18.5% year on year).

The domestic business of Austrian banks also continued to grow in the first half of 2008. For instance, claims on domestic nonbanks rose by 5.5% to

[1] *UniCredit Bank Austria (BA), Erste Bank der oesterreichischen Sparkassen (Erste Bank), Raiffeisen Zentralbank (RZB), Bank für Arbeit und Wirtschaft und Österreichische Postsparkasse (BAWAG P.S.K.) and Österreichische Volksbanken-Aktiengesellschaft (ÖVAG).*

Chart 14

Balance Sheet Structure of the Austrian Banking Sector (unconsolidated)



Source: OeNB.

EUR 296.5 billion, compared with an annual growth rate of 2.4% in the first half of 2007. On the liabilities side, the volume of domestic deposits jumped 10.3% to EUR 266.3 billion, a development that reflects, among other things, the continued uncertainty in financial markets. The key driver behind this increase was a 49.3% surge in fixed-term deposits,[2] whereas sight deposits and savings deposits expanded only moderately (3.1% and 5.0%, respectively). Given the high volatility prevailing in financial markets, this development underlines the confidence depositors place in the Austrian banking system. The strong growth in fixed-term deposits also reveals a change in the saving behavior of Austrians, as demand for online saving instruments and traditional saving accounts is rising.

The volume of direct domestic issues to nonbanks expanded by 18.0%, thus growing above average year on year but at a slower rate than in previous periods. One-third of this increase can be attributed to the issuance of debt securities, and two-thirds to the issuance of other securitized liabilities.

Amid the financial turmoil, banks have been gradually closing out special off-balance sheet transactions (derivatives positions) since the third quarter of 2007, causing the underlying nominal values to drop to around EUR 1,929 billion by end-June 2008. In the first half of 2008, year-on-year growth in derivatives transactions remained far

[2] *Fixed-term deposits refer to all deposits, other than securitized assets, taken in from nonbanks with an agreed maturity.*

below the first-half 2007 result (+40.2%) but was still positive (+4.8%). In terms of transaction types, the share of interest rate derivatives dropped to 78.5%, while that of foreign exchange derivatives inched up to 20.4%.

Consolidated total assets, which in addition to the domestic business mainly reflect the transactions of Austrian banks' CESEE subsidiaries, had increased by EUR 124.3 billion (12.0%) to EUR 1,161.7 billion by the end of June 2008. The five largest banks accounted for 63.3% of this amount.

In the first half of 2008, the number of Austrian banking offices dropped slightly – by 19 – to 5,137 outlets (874 head offices and 4,263 branches). At the same time, staff numbers increased by 2.6% year on year to 68,618 full-time equivalents. Including the staff of Austrian subsidiaries abroad, the overall headcount increased by 13.6% to 214,323 employees.[3]

Financial Market Developments Dampen Profits

As a result of the turbulence in international financial markets, banks operating in Austria, above all the larger ones, already began to see profits decline in the first half of 2008. Unconsolidated operating profits grew by EUR 2.9 billion in the first half of 2008, down EUR 0.4 billion or 11.2% compared to the same period last year. This decline in profit growth – the first since 2002 – is attributable to a decline in operating income by EUR 0.2 billion (1.8%) to EUR 8.4 billion, and to a rise in operating expenses by EUR 0.2 billion (4.0%) to EUR 5.5 billion. Consequently, the banks' unconsolidated cost-to-income ratio increased by 3.7 percentage points year on year to 65.8%; to some extent, this increase reflects the fact that the ratio was at a historically low level in 2007 due to particularly favorable macroeconomic and macrofinancial conditions. The decline in operating income in the first half of 2008 was strongest in the joint stock bank sector. In contrast, the Raiffeisen and Volksbank networks of cooperative banks even managed to raise their operating income. Unlike in the Raiffeisen sector, however, this increase did not translate into an improved cost-income ratio for the Volksbank sector due to an above-average surge in operating expenses.

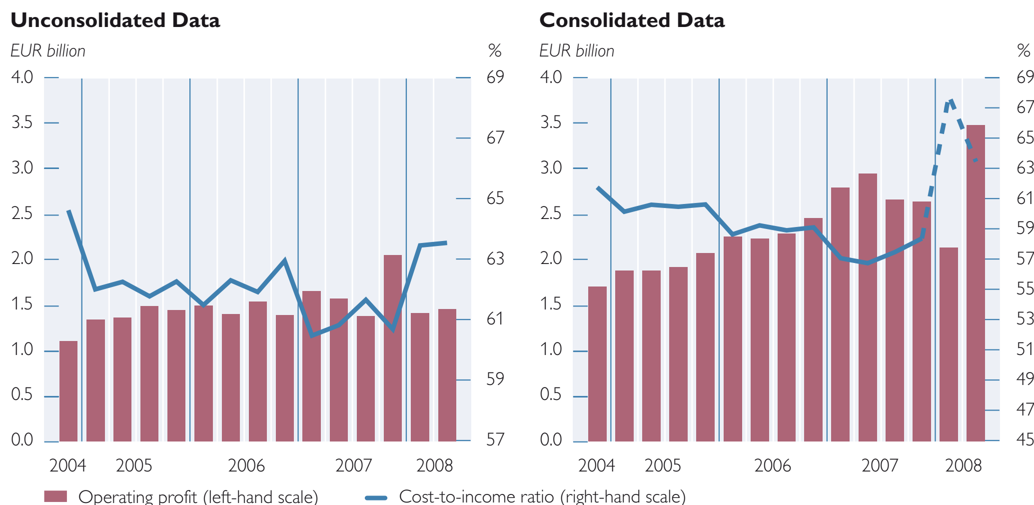
As a result of the financial turmoil, banks mainly suffered setbacks in fee-based income and a sharp drop in the net result of financial operations. In light of depressed demand for capital market products among nonbanks, the income generated by fee-based financial services – EUR 2.2 billion – remained EUR 0.3 billion or 12.0% below the result for the first half of 2007. Consequently, the share of operating income attributable to fee-based services dropped 3 percentage points to slightly below 25.8%. Given persistently unfavorable market conditions, the outlook for fee-based services remains difficult. The net result of financial operations was even negative for the first half of 2008 (–EUR 55.2 million).

In contrast, interest income continued to increase at a solid rate, climbing to almost EUR 4.0 billion in the first half of 2008; this represents an increase of 11.5% compared with the first half of 2007. Since the interest margin has remained virtually unchanged at its historically low level of 0.94% since

[3] *The development of staff numbers is based on reported headcounts and reflects both the organic growth of banks and staff additions through the acquisition of new entities.*

Chart 15

Comparison of Unconsolidated and Consolidated Operating Profit



Source: OeNB.

Note: The bars reflect the operating profit at the end of either the second or fourth quarter of each year (data are not cumulated). Due to changes in the financial reporting regime at the beginning of 2008, the consolidated cost-income ratio for 2008 and beyond is not comparable with pre-2008 data.

mid-2007, the gains in interest income were mainly volume-driven. Moreover, the stable interest margin indicates that banks were generally able to pass on higher interbank rates arising from tight liquidity conditions on the interbank market to their clients, at least in the first half of 2008. Yet keeping the interest margin from dropping lower still remains a challenge for banks, especially as the share of net interest income in total operating income[4] rebounded to approximately 47.5% in the first half of 2008 (from 41.8% in the first half of 2007).

Following particularly strong annual growth in previous quarters, income from equity investments rose by 6.0% to nearly EUR 1.5 billion up to the end of June 2008. At the same time, the corresponding share in total operating income rose to 17.5% (from 16.3% in the first half of 2007). Other operating income moved up by 9.1% to EUR 0.8 billion.

On the expenditure side, administrative expenses climbed EUR 0.3 billion (6.7%) to EUR 4.8 billion, with the increase in staff costs (+8.1%) markedly exceeding the rise in expenditure for goods and services (4.5%). The high growth in staff costs was, however, partly offset by one-off effects relating to the release of pension fund reserves. The share of administrative expenses in total expenses edged up compared with the corresponding period, namely to 86.3%. Administrative expenses other than staff costs or expenditure for goods and services dropped considerably by 15.1%, yet given their small share – 8.4% – in total operating expenditure, this decline had only a minor impact on the overall result.

[4] *It should be noted that the negative net result of financial operations has resulted in a slight upward bias in the other components of overall operating income.*

Strong Cross-Border Business Prevented Sharper Decline in Profits[5]

Consolidated operating profits for the first half of 2008,[6] which also include the activities of the Austrian banking sector in the CESEE region, dropped by EUR 0.1 billion (2.2%) to EUR 5.6 billion compared with the first half of 2007. In other words, cross-border transactions largely offset the decline in domestic profits. However, while consolidated operating profits jumped 20.7% year on year, operating expenses[7] surged by 36.8%. The consolidated cost-income ratio had thus risen to 66.6% by the end of the second quarter of 2008. Adjusted for taxes and minority interests, the consolidated end-of-period result showed a year-on-year decrease of EUR 0.2 billion (6.8%) to EUR 3.3 billion.

Box 2

Chronicle of the Global Financial Turmoil and Its Repercussions on Austria's Financial Market

Global financial markets have been in the throes of financial turmoil since the summer of 2007. In early September 2008, the continued downturn in the U.S. real estate market sparked renewed speculation among financial market participants as to whether the two finance giants operating in the U.S. secondary mortgage market – Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan and Mortgage Corporation), both chartered by Congress but privately run companies – were indeed adequately capitalized. Given the high relevance of Fannie Mae and Freddie Mac for the stability of international financial markets and for the U.S. real estate market, the U.S. government placed them under conservatorship and took sweeping measures, including the provision of explicit government guarantees for their liabilities.

In mid-September 2008, the market showed fresh signs of anxiety after Lehman Brothers, the fourth-largest U.S. investment bank, filed for chapter 11 bankruptcy protection. The insolvency of Lehman Brothers raised uncertainty in international markets considerably, as the company had been a major counterparty in the credit derivatives and swap market. The U.S. investment bank Merrill Lynch, Wall Street's third-largest bank, also suffered from the impaired functioning of the money market and from soaring write-downs, but was ultimately rescued through a takeover by Bank of America. The two remaining U.S. investment banks, Goldman Sachs and Morgan Stanley, finally, filed requests with the U.S. Federal Reserve to become bank holding companies, giving them above all improved access to the Fed's liquidity operations and allowing them to take deposits from investors.

The uncertainty was further heightened by reports that American International Group (AIG), one of the world's largest insurers, suffered a liquidity shortfall following the downgrade of its credit rating. Given its higher exposure to structured credit products, AIG was hit harder than other insurance companies. The Fed came to AIG's rescue with a loan in mid-September 2008, and subsequently revised and expanded the rescue package in early October and early November 2008.

By the end of September 2008, the liquidity problems had spread to a number of European credit institutions. Market participants raised doubts that the Belgian-Dutch financial group Fortis was adequately capitalized and had sufficiently liquidity. The governments of

[5] *The OeNB implemented the FINREP taxonomy for prudential reports at the beginning of 2008. Given this major structural break in the consolidated data series, historical changes need to be interpreted with caution.*

[6] *As banks use different accounting standards, aggregated consolidated data may convey a slightly distorted picture.*

[7] *Given the switch to International Financial Reporting Standards, comparability of the 2008 data on operating expenses with the data for 2007 is limited.*

Belgium, France and Luxembourg took swift action in support of Fortis and of the Belgian-French group Dexia. Next, Germany's Hypo Real Estate (HRE) bank encountered serious refinancing difficulties, but was rescued with the help of a credit line established by several other banks and guaranteed by the German government.

Up to mid-September 2008, troubled banks had mostly managed to improve their capital and liquidity base by selling off assets or raising capital. The demise of Lehman Brothers, the largest bankruptcy in U.S. history, marked the beginning of a new phase of financial turmoil. Stock prices plunged, credit risk premia soared, and conditions on the interbank market tightened even further. Increased concerns about counterparty creditworthiness and uncertainty about their own liquidity needs prompted banks to either hoard liquidity or lend funds only for very short terms and/or against collateral. In the unsecured money market, liquidity was scarce for maturities exceeding one week and even dried up completely for longer maturities.

Against this backdrop, central banks and governments responded with a number of measures to restore confidence and stability in the markets. On several occasions, the ECB and other central banks injected liquidity into the interbank market. Moreover, the swap lines established between the U.S. Fed and other central banks (including the ECB) were expanded, and new credit facilities were created or existing facilities were increased. In early October 2008, the world's major central banks cut key interest rates in a concerted action. The U.S. government announced a deal to rescue the U.S. financial system, which basically enables the U.S. Treasury to buy bad debt (residential and commercial mortgages as well as securities backed by those mortgages) from ailing banks and/or provide capital injections into the banking sector. In Europe, the heads of EU Member States endorsed a joint action plan to fight financial turbulence. This plan empowered governments to raise the savings guarantee for depositors, to provide fresh capital – secured by government guarantees – in order to recapitalize banks, and to underwrite certain bank obligations. At the same time, short-selling was banned at a number of stock exchanges, at least temporarily. These measures helped calm market fears to some extent.

In this context, Austrian policymakers also agreed on a comprehensive package to secure savings, strengthen banks and prevent disadvantages of competitiveness. The direct exposure of Austrian banks to the U.S. subprime crisis was comparatively limited given their deposit-based banking regime and their strong regional focus on the CESEE area. Yet as the turmoil spreads across Europe, the Austrian banking system is also faced with higher refinancing costs, declining trade and shrinking fee-based income, and a general increase in risk aversion among investors. The latter aspect is particularly relevant for Austria's exposure to CESEE as, following the financial meltdown in Iceland, countries in the region with large external imbalances now face greater scrutiny. At any rate, the Austrian Financial Market Authority FMA and the OeNB will continue to monitor developments in international financial markets closely and maintain close contact with their international counterparts as well as domestic banks and insurance companies.

Sustained Loan Growth Despite Difficult Environment[8]

Despite the crisis of confidence in international financial markets, which has also affected the refinancing conditions and credit standards in the Austrian banking sector, domestic credit institutions saw stable loan growth in the first half of 2008. While lending standards for both businesses and households were tightened, loan demand from businesses remained stable and that from households even edged up.[9]

[8] *The analysis of loan growth is based on the unconsolidated asset statement in the prudential statistics.*

[9] *Data on banks' lending policies are based on the bank lending survey of July 2008. The bank lending survey is conducted four times a year among senior loan officers of a representative sample of euro area banks.*

Retail interest rates on new loans also reflected tighter lending standards and higher refinancing costs. In the first half of 2008, interest rates on both loans to households and to nonfinancial corporations increased slightly compared with end-2007.[10] Annual interest rates on consumer and housing loans rose from 6.56% to 7.14% and from 5.27% to 5.34% respectively. Interest rates on corporate loans up to EUR 1 million increased from 5.50% to 5.61%, and rates on loans over EUR 1 million climbed from 5.09% to 5.12%.

Between January and June 2008, lending to domestic customers[11] grew at a steady pace of more than 6% year on year, with lending to nonfinancial corporations expanding significantly more rapidly than lending to households (8.2% vs. 4.3%). The growth of loans to nonfinancial corporations was above average in the savings bank, Raiffeisen and state mortgage bank sectors, while household loans increased particularly strongly in the Volksbanken and building and loan association sectors. Joint stock banks, by contrast, posted significantly lower loan growth rates. Broken down by individual bank, growth rates differed substantially among the five largest Austrian banks. Aggregated over all banks, annual loan growth was below average at around 3.1%. The median annual growth of all Austrian banks' claims on domestic customers[11] came to 5.4%.

The current financial market turmoil will eventually feed through to domestic loan growth, but the Austrian tradition of close, long-term relations between banks and customers ("house bank principle") will help cushion the effects of adverse international developments also in economically difficult times.

Financial Market Developments Highlight Risks of Foreign Currency Loans[12]

The decline in borrowing in foreign currency seen in previous periods stopped – at least temporarily – in the first half of 2008. This trend interruption was not attributable to increased new borrowing but largely traceable to the impact of exchange rate developments. The appreciation of the Swiss franc since end-2007 has clearly highlighted the risk of foreign currency loans.

While the share of foreign currency-denominated claims on domestic customers in total claims had dropped from 17.3% in mid-2007 to 16.2% at end-2007, it increased yet again more recently (17.0% in mid-2008). The amount of foreign currency loans outstanding to customers (nonbanks) totaled EUR 50.2 billion in mid-2008.

A breakdown by economic sector reveals that the share of foreign currency lending to households remained broadly unchanged – at 29.0% – year on year, whereas the respective share of lending to nonfinancial corporations decreased from 8.9% to 8.4%. The shares of currencies in foreign currency lending altered only marginally. While the Swiss franc kept its role as the most important currency in foreign currency lending, accounting for an almost unchanged share of just below 89%, the

[10] *Comparison of average annualized agreed rates between December 2007 and August 2008, covering intrayear interest payments on deposits and loans, but no other charges that may apply.*

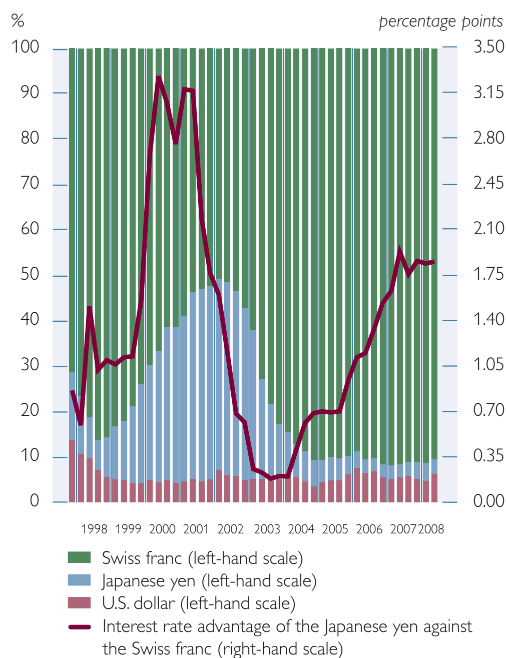
[11] *"Domestic customers" comprises the economic sectors "nonfinancial corporations," "households" and "nonprofit institutions serving households."*

[12] *All data on foreign currency loans are based on prudential reporting and deviate slightly from monetary statistics data. Excluding exchange rate effects.*

shares of the U.S. dollar and the Japanese yen edged up slightly to 6.1% and 3.3% respectively. The shares of all other currencies dropped below the 2% mark.

Chart 16

Foreign Currency Loans by Currency



Source: OeNB, Bloomberg (3-month interbank interest rates).

As at June 2008, 78.4% of foreign currency loans taken out by domestic households and nonfinancial corporations were bullet loans, 79.0% of which had been arranged with repayment vehicles. Bullet loans denominated in foreign currency were more common among households (84.8%, 87.6% of which with repayment vehicles) than among nonfinancial corporations (57.3%, 37.2% of which with repayment vehicles).[13] At the moment it is impossible to provide a reliable estimate of the losses sustained in connection with repayment vehicles during the current financial crisis. In fact, whether foreign currency borrowers have suffered losses depends very much on the type of repayment vehicle and on the residual maturity of their loan. The longer the period until repayment is due, the better are the chances that the repayment vehicle can make good on past losses. The available data show that since, at end-June 2008, around 95% of all foreign currency loans taken out by households and nonfinancial corporations in Austria had a residual maturity of more than 5 years and significantly more than 80% had a residual maturity of more than 10 years, the impact of the financial market turmoil will depend very much on the medium to long-term performance of the associated repayment vehicles.

The extremely high volatility seen in international capital markets recently has put into focus the danger of bullet loans arranged with repayment vehicles, which, in addition to other risks, are exposed to exchange rate risk.

Credit Quality in Terms of Risk Provisions Still Considered Good

The available data[14] on banks' credit risk provisions have not yet mirrored the gloomier economic outlook. The unconsolidated loan loss provision ratio[15] for the entire Austrian banking system continued its sharp downtrend, dropping by 0.35 percentage points to 2.33% between mid-2007 and mid-2008.

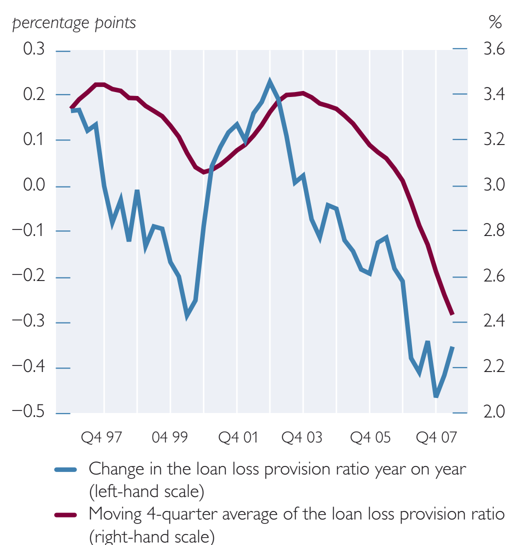
[13] *Only 27.3% of euro-denominated loans to domestic households and nonfinancial corporations in Austria were bullet loans; 10.6% of these loans had been arranged with repayment vehicles.*

[14] *As at mid-2008.*

[15] *Specific loan loss provisions for claims on nonbanks as a proportion of total outstanding claims on nonbanks. Claims in this context are defined as loans and unlisted debt securities.*

Chart 17

Unconsolidated Loan Loss Provision Ratio of Austrian Credit Institutions



Source: OeNB.

The acceleration of the decline in the loan loss provision ratio, which had been observed for almost four years, came to a halt during 2008 (blue line in chart 17). In view of the changed economic conditions and the low level that loan loss provisions have now reached, a trend reversal seems unavoidable. During the most recent downturn at the beginning of this decade, the time lag between when the first falling growth figures were recorded and when loan loss provision ratios started to pick up was about one and a half years. From a present perspective, it is difficult to predict the amount of additional loan loss provisions and the period over which these provisions will have to be made available. Under the assumption that the amount of outstanding claims remains unchanged, raising the current unconsolidated loan loss provision ratio to 3% – approximately the lowest level reached at the end of the last business cycle – would require additional loan loss provisions of EUR 2.8 billion; this amount almost equals Austrian credit institutions' total operating profits (on an unconsolidated basis) in the first half of 2008.

Available consolidated data confirm the trend of declining unconsolidated loan loss provision ratios seen over the past few years. In the aggregate of those groups which submit supervisory reports under IFRS,[16] the ratio of allowances to the total amount of loans and receivables decreased fairly steadily over the past five years, from 3.0% to 1.9% by mid-2008.[17] If the downtrend in the consolidated loan loss provision ratios reversed and half of the decline of the past five years would be made up for – i.e. if the consolidated ratio rose to 2.4% – additional loan loss provisions would come to EUR 3.9 billion.[18] This corresponds to almost 90% of the consolidated operating profits of IFRS reporters in the first half of 2008.

[16] *These groups' share in the consolidated total assets of the Austrian banking system was 82% in mid-2008.*

[17] *These figures cannot be compared with the unconsolidated loan loss provision ratios because, among other things, allowances for loans and receivables are not available for nonbanks separately and the consolidated ratios therefore refer to banks as well.*

[18] *Again assuming an unchanged amount of claims.*

Box 3

Prudential Procedures under Pillar 2

The EU directives central to banking supervision, 2006/48/EC and 2006/49/EC, implementing the framework of the New Basel Capital Accord (Basel II), do not only set out the methods for assessing regulatory minimum capital requirements (pillar 1) and disclosure requirements (pillar 3), but also place increased emphasis on risk management and integrated bank-wide management and control. This supervisory review process (pillar 2) comprises provisions that apply to both institutions under supervision (on the establishment of appropriate procedures and systems to ensure capital adequacy while taking account all material risks) and to supervisors (on assessing internal capital adequacy and the procedures applied). When designing and evaluating the processes under pillar 2, supervisors and credit institutions are to take due account of the type, scope and complexity of the banking transactions conducted (principle of dual proportionality).

The provisions under pillar 2 were transposed into Austrian law through Articles 39 (General due diligence obligations) and 39a (Internal capital adequacy assessment process) as well as Articles 69 para 2 and 3 (ongoing supervision) of the Austrian Banking Act. Articles 69, 70 and 79 para 4a of the Austrian Banking Act define the areas of responsibility of the Financial Market Authority FMA and the Oesterreichische Nationalbank (OeNB). The specific implementation of pillar 2 in Austria is based on international standards, including, in particular, the Core Principles of Banking Supervision issued by the Basel Committee on Banking Supervision and the Guidelines on the Application of the Supervisory Review Process under Pillar 2 provided by the Committee of European Banking Supervisors (CEBS).

Under the supervisory review process, national supervisors are required to conduct, on a standardized basis, assessments of measures, strategies, processes and mechanisms at individual bank level. Applying their own systems, supervisors are to provide an overall assessment of the risk situation (Risk Assessment System, RAS). The tools available to supervisors in fulfilling this task include on-site inspections and, in particular, the ongoing analysis and assessment of banks. Taking account of the principle of proportionality in terms of scope and depth, the OeNB's individual bank analysis, which covers all Austrian credit institutions, is a two-stage process, consisting of the elements basis analysis and detailed analysis. Furthermore, ongoing model supervision includes all measures pertaining to the use of models subject to approval requirements once they have been approved.

In the course of ongoing supervision, compliance with pillar 2 requirements is reviewed on an annual basis (again taking account of the principle of proportionality). This annual evaluation focuses on selected issues and relies on all sources of information available to the supervisory authority, including the bank auditor's report for the purpose of initial assessment. In addition, detailed information is collected by drawing samples in the course of full evaluations and on-site inspections. Once again taking account of the principle of proportionality, these evaluations are carried out in a way consistent with a credit institution's systemic relevance and the type, scope and risk level of its transactions. Intense interaction between banks and supervisors (structured dialogue) is considered to be of particular importance in this context.

The reform of banking supervision in Austria, which took effect in January 2008, provided for the FMA and the OeNB cooperating closely and coordinating processes and procedures to ensure an integrated approach to supervision. The new legislation explicitly defines the OeNB's responsibility for the off-site analysis and the on-site inspection of banks (fact finding) and the FMA's role as the public authority responsible for decision taking. The clear definition of the OeNB's and the FMA's tasks, powers and responsibilities in the prudential process has helped speed up communication and ensure a risk-oriented allocation of resources. To provide for an efficient flow of relevant information, a "single point of contact" concept (SPOC) was introduced in early 2008, assigning each credit institution and each banking group to one nominated contact person at the OeNB and one at the FMA.[1]

[1] Both SPOCs cooperate closely, with the OeNB SPOC responsible for on-site inspection and analyses and the FMA SPOC responsible for all official action and monitoring.

A joint database in operation since January 2008 and an inter-institutional workflow to be implemented from end-2008 also contribute to efficient communication between the OeNB and the FMA. In addition, essential supervisory information and relevant official documents are presented to both institutions' senior management in the newly established FMA-OeNB "individual bank forum." The forum has been created to contribute to a joint perspective and an effective and efficient preparation of decisions; it has been smoothly integrated in the new supervisory framework implemented earlier in 2008.

Market Risk: Limited Direct Exposure

Capital requirements for position risk[19] on an unconsolidated basis were decreasing in the first half of 2008, both in absolute terms and as a percentage of total capital requirements. The latter, which in general can be considered an approximation of the individual risk categories' relative importance to the Austrian banking system, dropped by 0.6 percentage points to 3.3% in the case of market risk. By contrast, capital requirements for credit risk as a percentage of total capital requirements came to 90.4% in mid-2008, while the equivalent share for operational risk was 5.2%. Consolidated figures at the group level do not yield substantially different shares of the individual risk categories in total capital requirements and thus confirm the minor importance of market risk.

Within market risk, interest rate risk remained the dominant risk category, accounting for capital requirements of EUR 857 million in mid-2008, down by EUR 226 million compared with the beginning of the year (unconsolidated data). Capital requirements for equity positions edged up by EUR 24 million to EUR 205 million in the first half of 2008; similarly, capital requirements for foreign exchange positions increased (from EUR 74 million to EUR 100 million). These figures suggest that the loss potential stemming from market risks contained in Austrian banks' trading activities is limited. Provided that the credit institutions continue to consistently apply established risk management methods it can be assumed that banks' trading activities will not seriously jeopardize the soundness of the Austrian banking system.

Banks are exposed to market risk not only through their trading activities but also through the interest rate risk in the banking book.[20] The Basel ratio for interest rate risk[21] is an indicator for the interest rate risk in the banking book calculated by credit institutions as a part of supervisory reporting. At the level of the Austrian banking system as a whole,[22] this ratio remained at a steady 4.5% in the first half of 2008, i.e. the downward trend seen in previous years

[19] *Position risk refers to the risk of value changes triggered by stock price and interest rate fluctuations in respect of positions in the trading book, as well as to the risk of value changes arising from exchange rate and commodity price fluctuations in respect of all bank positions. This risk is also commonly referred to as market risk.*

[20] *There are no explicit regulatory capital requirements for the interest rate risk in the banking book, but banks are required to ensure adequate capital endowment that takes account of the interest rate risk in the banking book as well.*

[21] *This ratio is calculated for all credit institutions on an unconsolidated basis. It is defined as the ratio between the change in the present value of the banking book that follows a parallel yield curve shift of 200 basis points for all currencies and the unconsolidated eligible own funds. The change in the present value takes account of solely the risk of a general move in the yield curve associated with maturity transformation (yield curve risk). Basis risks associated with different interest rate changes on the asset and the liability side – which may be due to, for instance, tighter refinancing conditions – are not considered.*

[22] *A total asset-weighted average of the Basel ratio of all banks is used as an indicator for the entire system.*

had come to an end. Large banks usually post ratios (sometimes significantly) below the average value of the entire banking system, which can be attributed to these banks' active interest rate book management through interest rate derivatives.

All considered, direct market risks are therefore a limited source of risk to the Austrian banking system. Through different channels, however, there is some interaction between individual market risk factors and credit risks which Austrian banks are exposed to. This applies to bullet loans, for instance, in which the value of the repayment vehicle used to pay off the capital at the end of the loan depends to some extent on stock price developments, to variable rate loans, in which interest payments are determined by money market rates, and to foreign currency loans, in which the exchange rate between the loan currency and the euro affects the amount of interest and capital payments.[23]

Austrian Banks Maintain Sound Liquidity Profile despite Global Market Turmoil

Liquid claims (with maturities of up to three months) and liquid assets (e.g. euro government bonds) held by Austrian banks as at June 30, 2008, amounted to 112.8% of short-term liabilities (with maturities of up to three months). In other words, Austrian banks are in a position to absorb even an unexpected negative liquidity shock (such as a further tightening of refinancing conditions in the euro money market).

Analyzing the cumulative net funding gap produces a similar picture. The net funding gap is calculated based on data reported for the residual maturity statistics, where assets and liabilities are netted in three maturity bands (next banking day, up to one month, up to three months). Consideration is given to positions vis-à-vis both banks and nonbanks on both sides of the short-term balance sheet. The net positions are subsequently totaled over the three maturity bands. Austrian banks' cumulative net funding gap is inevitably negative, given the pivotal role of the banking system and the associated maturity transformation. From the second quarter 2007 to end-2007, this indicator rose from 11.7% of total assets to 14.4%. In response to the turmoil in the euro money market, Austrian banks cut back this value to 10.3% by June 30, 2008. Banks hedge the liquidity risk that comes with a negative cumulative funding gap by holding liquid assets. The Austrian banking system's coverage of the cumulative net funding gap by liquid assets increased sharply – to 164% – in the first half of 2008 compared with end-2007. After recording a rise at end-2007, banks hence reduced their liquidity risk to the level before the financial crisis (second quarter 2007: 162%). Austrian banks' cumulative net funding gap vis-à-vis other banks in Europe is only 3.5% of total assets, its coverage by liquid assets equals 484%. As the financial turmoil turned into a major crisis, Austrian banks have apparently sought to reduce their exposure to liquidity risk. Due to tightening conditions in the money and capital markets in the second half of 2008, there have been limits to these efforts, however, as refinancing maturities have become shorter and costs have risen.

[23] *In addition, foreign currency loans usually include the previously mentioned factors (variable interest rates, repayment vehicles).*

Austrian banks are highly resilient to liquidity shocks, as was confirmed by the results of stringent liquidity stress testing conducted under the IMF's FSAP update. The resilience is attributable above all to the very sound financing structure of Austrian banks by international standards, where customer deposits play a greater role than in other banking systems.[24] Amid the financial market turbulence, bank deposits have become even more important for Austrian households. 72% of new investment in the first half of 2008 were bank deposits. This took some of the edge off the tighter refinancing conditions in the euro money market and reduced dependence on more volatile money market financing options.

In view of the current euro money market situation, the OeNB has significantly reinforced its monitoring of market liquidity and maintains close contact with market participants. As part of these stepped-up activities, the OeNB has introduced a weekly liquidity monitoring system for large Austrian banks. This monitoring has shown so far that the refinancing conditions in the money and capital markets are indeed tight and that the liquidity risk has risen also in Austria but has highlighted at the same time that all Austrian large banks, with one exception, maintain a sufficient liquidity cushion to compensate for short-term net funding gaps. The adoption of the bank support package in Austria, which included the creation of a clearing house and the provision of government guarantees for bank issues, could contribute to reducing liquidity risk in the months to come.

Harmonized Oversight of Card Payment Schemes

The EU-wide harmonization of oversight activities has made progress also in the field of card payment schemes. In January 2008 the ECB Governing Council approved the "Oversight Framework for Card Payment Schemes,"[25] which lays down Eurosystem oversight standards, focusing, in particular, on ensuring the safety and efficiency of card payment schemes. The standards provide the basis for regular oversight assessments; card payment systems operating cross-border in the euro area[26] are subject to cooperative oversight by assessment groups composed of several national central banks, including the OeNB.

The card payment schemes operating in Austria have been required to submit quarterly reports to the OeNB's payment systems statistics since 2004. The number and value of transactions have been rising continuously since reporting started. Direct debit payment systems (above all Maestro/POS) accounted for the lion's share of transactions, recording around 136.6 million transactions in the first half of 2008. By contrast, owing to the general market environment the number and value of transactions processed through securities settlement systems decreased compared with the second half of 2007 (by 15.5% and 5.7%, respectively).

The vast bulk of transactions in terms of value was processed through the OeNB's system HOAM.AT,[27] however. Recording 1.6 million transactions to the total value of EUR 2,360

[24] *At end-2008, bank deposits accounted for 45.7% of Austrian households' financial assets, which represents a very high share by international standards.*

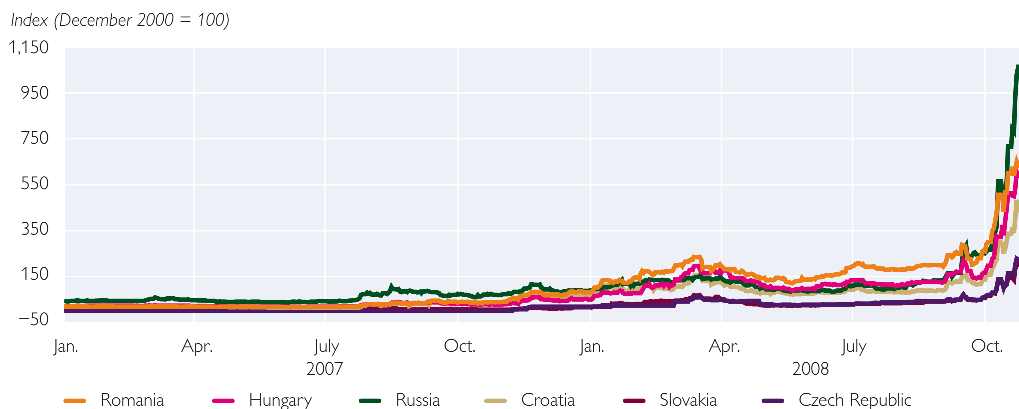
[25] *http://www.ecb.int/pub/pdf/other/oversightfwcardpaymentsss200801en.pdf.*

[26] *MasterCard, VISA, AmericanExpress and Diners.*

[27] *The Home Accounting Module Austria (HOAM.AT) is a real-time gross settlement system for processing euro payments provided by the OeNB to participants.*

Chart 18

5-Year Senior CDS of Selected CESEE Countries



Source: OeNB, Bloomberg.

billion in the first half of 2008, HOAM.AT continued to be the central payment system in Austria. Likewise, the large-value payment system EURO1 remained the most important international payment system for domestic banks in terms of value, processing transactions worth some EUR 841.6 billion in the period under review. In terms of number of transactions, the international retail payment system STEP2 kept its leading position with some 10.2 million processed transactions.

As to system security, the first half of 2008 saw one system disruption[28] in HOAM.AT and a total of 35 system disruptions in retail payment systems of small infrastructure providers. None of these disturbances had a negative impact on the Austrian financial system.

Higher Exposures and Uncertainty in CESEE

Austrian banks' expansive activities in CESEE were a key reason why the Austrian banking system was hardly directly affected initially when the financial turmoil started to take hold in mid-2007. Though 5-year senior CDS spreads, a measure of investor confidence, started to increase – some significantly – also for CESEE countries from July 2007 (see chart 18), until summer 2008 this rise was seen in the context of a global risk repricing. In addition, hopes were that the real effects of the financial crisis in CESEE would facilitate a soft landing of economies threatened by overheating.

When the financial turbulence gathered momentum in the third quarter of 2008 and its repercussions were increasingly felt in Europe too, the risk positions of some CESEE countries also attracted more attention. The economic outlook for Europe as a whole had to be revised; likewise, the outlook for CESEE also became gloomier. The severe disruptions in the Icelandic economy furthermore indicated that, under the current capital market conditions, large-scale economic imbalances may be corrected relatively abruptly. Consequently, uncertainty in the CESEE countries that depend particularly heavily on external financing increased. In addition, political developments in

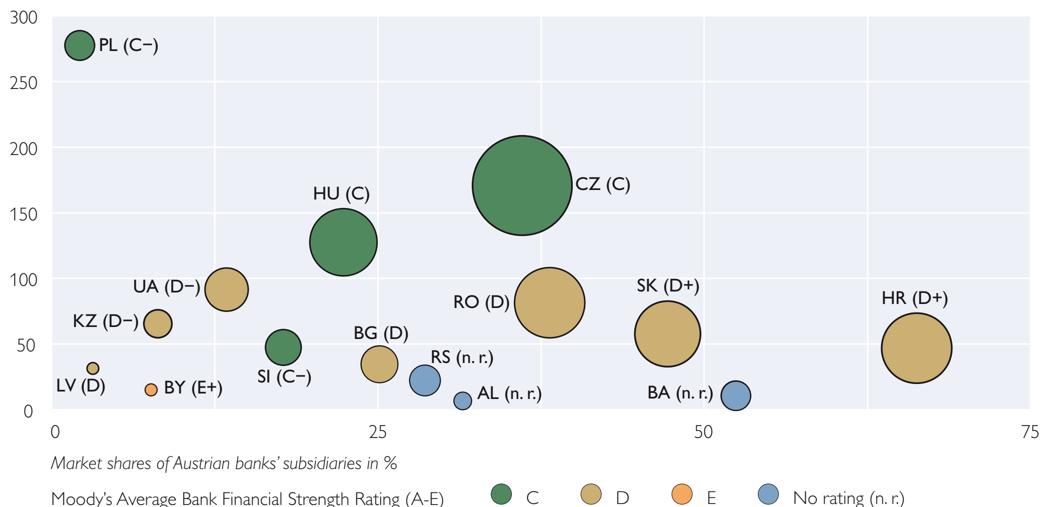
[28] *A system disturbance is defined as the unavailability of the payment system for more than 30 minutes during business hours or within the last 30 minutes before settlement cut-off.*

Chart 19

Market Shares of Austrian Banks' Subsidiaries in CESEE

As at June 30, 2008

Aggregated national total assets of banks in EUR billion



Market shares of Austrian banks' subsidiaries in %

Moody's Average Bank Financial Strength Rating (A-E) C D E No rating (n. r.)

Source: OeNB, national central banks, Moody's Investors Service.

Note: The chart shows the individual countries according to the Austrian subsidiary banks' market share (x-axis) and the aggregated total assets of the national banking industry (y-axis). The size of the circle corresponds to the total exposure of Austrian banks vis-à-vis the respective country. The countries are colored according to Moody's average bank financial strength (BFS) rating.
Because of the large size of the Russian banking sector (EUR 625 billion as at mid-2008), the chart does not show Russia, where Austrian subsidiaries held a market share of 3.8%. Apart from this, the chart shows all countries where Austrian subsidiaries record aggregated total assets of at least EUR 1 billion. Recent acquisitions in CIS countries (with the exception of Kazakhstan) and in Montenegro are thus not reflected.

some of the Commonwealth of Independent States (CIS) contributed to changes in investor sentiment. As a result, 5-year senior CDS spreads climbed to hitherto unprecedented levels by mid-November 2008.

The latest available data for the first half of 2008, which serve as the basis for the analysis below, do not yet reflect the most recent changes in the business environment in CESEE. Still, this information is of key importance to the banks active in the region, since Austria's large banks earn the bulk of their profits in CESEE. According to the data in the business segment reports submitted to the OeNB, large Austrian banks' activities in CESEE generated consolidated profit before taxes of EUR 3.3 billion in the first half of 2008. This substantial amount in comparison with the figures for the Austrian business segment (EUR 1.0 billion) and the rest of the world (–EUR 0.3 billion) underlines the major importance of the CESEE segment.

The data reported also confirm continued healthy growth of total assets – by some 20% to EUR 330.8 billion – in the region in the first half of 2008.[29] The aggregated total assets of the CESEE business segment hence accounted for 28.5% of the consolidated total assets of all Austrian banks at end-June 2008 (against 25.7% in the fourth quarter of 2007). Owing to the changed economic environment, it can be assumed that in the short and medium term Austrian banks' activities in CESEE will not continue to expand at

[29] *This figure for total asset growth was not distorted by significant restructuring in the first half of 2008 and is therefore based on the organic growth of existing subsidiaries and the expansion of cross-border direct lending.*

the same rate as previously; the long-term growth perspective, however, is set to remain positive.

All in all, at end-2008 twelve Austrian banks operated 73 fully consolidated subsidiaries in CESEE (not including Yapi Credit, Bank Austria's nonfully consolidated joint venture in Turkey). Of these 73 subsidiaries, 30 are doing business in those countries of the region that joined the EU in 2004 (NMS-2004),[30] seven in those that joined the EU in 2007 (NMS-2007),[31] 23 in the remaining Southeastern European (SEE) countries[32] and 13 in CIS countries.[33] Chart 19 illustrates the absolute importance of the region to the Austrian banking system in terms of the aggregated unconsolidated total assets of its regional subsidiaries and its relative importance in the local markets in terms of market share. Austrian subsidiaries continued to play a prominent role in the region in the first half of 2009. Their share in the entire CESEE banking market decreased only marginally between end-2007 (15.3%) and mid-2008 (15.2%); if Russia is not included, the decline would have been from 22.7% to 21.8%).[34]

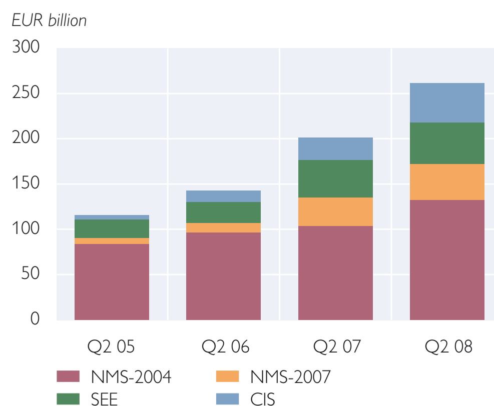
The analysis of the fully consolidated CESEE subsidiaries' unconsolidated total asset growth shows that expansion continued almost unabatedly in the first half of 2008 (see chart 20). Austrian banks hence contributed significantly to providing access to credit in the region also under the most difficult conditions. Owing to the further deterioration of the business environment in the second half of 2008, however, total asset growth can be expected to decelerate at least in the short term, as expanding lending without providing for additional own funds inevitably leads to a lower capital ratio. At the same time, investors are currently demanding higher capital ratios, which they consider a sign of a credit institution's higher risk-bearing capacity. Even healthy banks cannot afford in the present situation not to fulfill these expectations.

This situation can be expected to feed through to banks' market development strategies further (south-)east, where higher profits have gone hand in hand with higher risks. While accounting for more than 50% of the NMS-2004 banking sector's total assets, Austrian subsidiaries made only 41% of the regional sector's total earnings (some EUR 1 billion). In all other country groups, less capital investment pro-

Chart 20

Total Assets of Austrian Banks' Subsidiaries in CESEE

As at June 30, 2008



Source: OeNB.

[30] *NMS-2004: the Czech Republic (CZ), Hungary (HU), Latvia (LV), Poland (PL), Slovakia (SK) and Slovenia (SI).*

[31] *NMS-2007: Bulgaria (BG) and Romania (RO).*

[32] *SEE: Albania (AL), Bosnia and Herzegovina (BA), Croatia (HR), Montenegro (ME) and Serbia (RS).*

[33] *CIS: Belarus (BY), Kazakhstan (KZ), Kyrgyzstan (KG), Russia (RU), Tajikistan (TJ) and Ukraine (UA).*

[34] *Both figures excluding Turkey.*

duced higher gains. Austrian banks' subsidiaries in the NMS-2007 contributed 22% or EUR 550 million to total earnings (and accounted for a 15.2% share in the entire sector's total assets), SEE subsidiaries 17% or EUR 439 million (total assets share: 17.4%) and CIS subsidiaries 20% (total assets share: 16.5%). Profits in the first six months of 2008 remained stable against the quarterly growth rates, despite the global turbulence. The figures analyzed here, however, do not reflect the most recent developments since end-June 2008.

Austrian banks' indirect exposure through loans extended by CESEE subsidiaries illustrates the region's continued good access to credit provided by Austrian banks up to the second quarter of 2008. The total outstanding amount of loans extended by Austrian subsidiaries in the region advanced by 35.5% in the second quarter of 2008 against the same quarter of the previous year, coming to EUR 166.6 billion. Austrian banks' indirect exposure varied greatly within country groups: While the share of the NMS-2004 and the NMS-2007 remained more or less unchanged at 48.9% and 15.0% respectively, the SEE countries' share shrank by some 3.5 percentage points to 16.7%, while the CIS countries' share grew by about the same amount (19.4%).

Direct lending by Austrian parent banks picked up significantly in the first half of 2008. The total amount of loans extended directly by Austrian banks to customers in the region came to EUR 64.5 billion. Although growth rates differ – in part – substantially from country to country,[35] the CESEE EU Member States account for the lion's share of the total exposure. 55.8% of loans went to the NMS-2004, 13.3% to the NMS-2007, 23.2% to Southeastern Europe and 7.7% to the countries of the CIS.

Banking markets' and Austrian subsidiaries' risk positions can be assessed through internal ratings and by using external sources such as bank ratings. While the individual subsidiary ratings provided by Moody's have not (yet) reflected the deterioration of the business environment (see table 7), a change may be in the offing in the country ratings. Up to early 2008, the rating outlooks for the region were consistently positive, and up to mid-October, the actual downgrades were limited to countries which are of only marginal importance to Austrian banks (Standard & Poor's downgraded Kazakhstan and Lithuania in 2008). From October 2008 on, however, the large rating agencies issued qualitative analyses some of which described the outlook as deteriorating both at bank and country level. Early November saw the first downgrades relevant to Austrian banks. Moody's reduced the country ratings of Estonia, Latvia and Hungary, Fitch cut the ratings of Bulgaria, Kazakhstan and Hungary by one notch and Romania's rating even by two notches. The reasons cited for each downgrade were doubts about these countries' ability to absorb external shocks triggered by the financial crisis, given national macroeconomic imbalances. Consequently, Fitch also downgraded individual bank ratings, some of which affected the subsidiaries of Austrian banks.

[35] *As there were changes in reporting to the Central Credit Register in early 2008 (among other things, Austrian banks' direct loan exposure to the region has been included), a historical assessment of loan growth is possible only to a limited extent.*

Table 7

Average Ratings of Central, Eastern and Southeastern European Banking Systems and Selected Subsidiaries

As at November 13, 2008

Country	Bank	Deposits – LT	BFS Rating	Outlook
Bulgaria		Baa2	D	–
	Raiffeisenbank, Bulgaria	Baa3	D+	stable
Kazakhstan		Ba1	D–	–
Croatia		A2	D+	–
	Zagrebacka banka	Ba1	D+	stable
Latvia		Ba1	D	–
Poland		A1	C–	–
Romania		A3	D	–
	Banca Comerciala Romana	Baa3	D	stable
	Raiffeisen Bank	Baa3	D	stable
Russia		A3	D–	–
	ZAO Raiffeisenbank	Baa1	D+	stable
Slovakia		A1	D+	–
	Slovenská sporiteľňa	A1	C–	stable
	Tatra banka	A1	C–	stable
Slovenia		A1	C–	–
Czech Republic		Aa3	C	–
	Česká Spořitelna	A1	C	stable
Turkey		A3	D+	–
	Yapi ve Kredi Bankasi	B1	D+	stable
Ukraine		Ba1	D–	–
	Raiffeisen Bank Aval	B2	D	stable
Hungary		Aa3	C	–
	Erste Bank Hungary	A3	D+	stable
Belarus		Ba1	E+	–

Source: Moody's Investors Service.

Note: LT = long-term, BFS = bank financial strength.

Box 4

Banks in CESEE:[1] Mostly Sound Performance in the First Half of 2008, but Credit Risks Continue to Rise in Some Countries due to Exchange Rate Risks

Year-on-year growth in domestic lending to private nonbanks in mid-2008, expressed as a percentage of GDP,[2] was especially high in Slovenia, Bulgaria and Romania. Only in Romania, however, was this rate of expansion significantly above the corresponding value recorded at end-2007; this high rate was attributable to a large extent to the effect of the depreciation of the domestic currency (by 14% against the euro) on the credit expansion rate (calculated in national currency), which had a substantial impact due to the high share of foreign currency loans. By contrast, credit expansion was considerably lower in mid-2008 compared with end-2007 in Slovenia (albeit down from a very high level), in Croatia (very likely thanks to supervisory measures aimed at curbing credit growth) and in Hungary (presumably due to a stagnating domestic economy) in mid-2008 compared with end-2007. Both in Bulgaria (recording

[1] *This box describes the situation and development of all (domestic or foreign-owned) banks resident in these countries. For the most recent economic and financial sector developments in CESEE see section "Higher Exposure and Uncertainty in CESEE" of this Financial Stability Report.*

[2] *Total GDP of the four quarters from mid-2007 to mid-2008.*

strong domestic credit expansion) and in Croatia (posting lower and falling domestic credit expansion) cross-border financial debt[3] increased sharply (by 9.2% and 10.9% of GDP respectively), in both countries at a slightly faster pace than at end-2007.

Domestic Credit to Private Nonbanks

	2005	2006	2007	H1 08	2005	2006	2007	H1 08
	End-of-period change, % of GDP				*Real rate of change at end of period, %*			
Slovenia	11.3	13.9	20.3	18.4	21.5	22.5	26.1	19.3
Slovakia	7.8	7.2	7.8	8.0	23.5	18.5	19.5	17.3
Czech Republic	6.4	7.3	10.5	9.6	19.2	20.1	21.7	16.2
Poland	2.5	6.5	9.5	9.7	8.5	22.3	26.2	23.8
Hungary	8.1	7.9	9.7	8.3	15.1	9.5	10.6	8.4
Bulgaria	10.7	9.3	25.7	25.2	23.4	17.5	45.7	32.6
Romania	6.6	9.4	13.8	15.6	33.7	46.4	50.1	50.1
Croatia	9.5	13.6	9.9	7.2	13.4	20.7	8.7	2.7

Source: Eurostat, national central banks, OeNB.

Note: The real rate of change is derived by HICP adjustment

At mid-2008, the foreign currency share in outstanding domestic lending to enterprises and households was the highest in Croatia (including loans indexed to foreign currencies), Hungary, Romania and Bulgaria. Against end-2007, this share continued to decrease in Croatia thanks to measures taken by the supervisory authorities; in Slovakia and the Czech Republic the already relatively small foreign currency share also became smaller. In Bulgaria, by contrast, this share continued to increase notably, particularly owing to foreign currency lending to households.

Domestic Foreign Currency Loans to Private Nonbanks

	2003	2004	2005	2006	2007	H1 08
	End of period, % of total domestic loans to private nonbanks					
Slovenia	27.1	43.1	55.7	63.4	7.3	7.6
Slovakia	18.8	21.5	22.5	20.0	21.2	19.4
Czech Republic	12.8	11.2	10.0	10.4	9.1	8.4
Poland	30.6	25.3	25.9	27.0	24.2	24.8
Hungary	. .	. .	45.9	49.6	57.2	57.1
Bulgaria	43.6	48.2	47.3	45.1	50.0	53.7
Romania	55.4	60.8	54.7	47.4	54.3	55.1
Croatia	76.6	77.0	77.8	71.7	61.4	60.9

Source: National central banks, OeNB.

The foreign currency share in outstanding loans to households at mid-2008 was especially high in Croatia, Hungary and Romania. Above all in Bulgaria, Slovakia and the Czech Republic, the foreign currency share was significantly lower in lending to households than in lending to businesses, although the former recently rose strongly in Bulgaria. The high levels of foreign currency lending in Hungary and Romania continued to increase further, which may also be attributable to the relatively high interest rate differential between credit denominated in national and in foreign currency. Recently, however, foreign currency lending rose markedly in Slovenia (in Swiss francs) and Poland (predominantly in Swiss francs) too, whereas in Croatia, supervisors successfully curbed lending in foreign currency further.

[3] *Gross external debt of private nonbanks without intra-company loans and trade credits.*

Domestic Foreign Currency Loans to Households

	2003	2004	2005	2006	2007	H1 08
	End of period, % of total domestic loans to households					
Slovenia	1.0	22.5	37.4	41.7	15.2	17.5
Slovakia	. .	0.6	1.1	1.7	3.0	2.6
Czech Republic	0.5	0.3	0.3	0.2	0.2	0.1
Poland	. .	27.2	28.4	30.9	27.9	29.8
Hungary	. .	. .	29.2	42.7	55.1	58.9
Bulgaria	8.9	11.0	15.4	19.0	20.0	24.0
Romania	29.3	45.9	44.1	41.2	53.1	56.2
Croatia	81.2	79.4	80.0	77.7	67.3	65.7

Source: National central banks, OeNB.

A high share of foreign currency lending constitutes a risk to financial stability, as unfavorably developing exchange rates and/or increasing foreign interest rates could have a negative effect on borrowers' solvency, particularly since, above all, households and small and medium-sized enterprises (SMEs) might not be adequately hedged against such risks.

In Romania and the Czech Republic, bank profitability in terms of return on equity (RoE) after taxes was significantly higher in the first half of 2008 than in the corresponding period of the previous year, whereas in Hungary and – to a lesser extent – in Slovakia, bank profitability declined; in Hungary, this decrease can be attributed to weak domestic demand in the wake of fiscal consolidation measures.

Nominal Return on Equity

	2003	2004	2005	2006	2007	H1 07	H1 08
	%						
Slovenia	11.9	12.7	12.7	15.1	16.3	. .	. .
Slovakia	10.5	12.3	13.4	17.6	15.0	16.6	15.5
Czech Republic	17.8	18.1	18.4	17.1	19.2	18.7	19.9
Poland	5.5	17.4	24.0	21.6	24.0	26.5	26.8
Hungary	17.1	22.3	21.7	21.4	16.5	21.2	16.2
Bulgaria	14.8	16.6	18.0	19.7	21.5	20.6	21.6
Romania	17.7	17.7	15.1	11.6	10.5	12.5	15.6
Croatia	14.5	16.1	15.6	12.4	10.9	11.9	12.1

Source: National central banks, OeNB.

Note: Based on profits after tax. Half-year profits annualized linearly. Data are not comparable across countries.

The capital adequacy ratio dropped particularly markedly in Romania by mid-2008 compared with mid-2007, most likely a side-effect of the vigorous growth in lending to businesses and households. Slovakia and Poland also recorded deteriorating capital adequacy ratios, whereas Hungary and the Czech Republic posted improved ratios.

Capital Adequacy Ratio[1]

	2003	2004	2005	2006	2007	H1 07	H1 08
	%						
Slovenia	11.5	11.8	10.6	11.1	11.2	. .	. .
Slovakia	21.7	19.0	14.8	13.0	12.8	13.5	12.0
Czech Republic	14.4	12.5	11.9	11.5	11.5	11.8	12.4
Poland	13.8	15.4	14.5	13.2	12.1	12.4	10.9
Hungary	12.3	12.8	12.0	11.5	11.6	11.6	12.6
Bulgaria	22.2	16.6	15.3	14.5	13.8	14.4	14.5
Romania	21.1	20.6	21.1	18.1	13.8	15.0	12.8
Croatia	16.2	15.3	13.4	14.0	15.4	15.0	15.2

Source: National central banks, OeNB.

[1] Ratio of regulatory capital to risk-weighted assets.

Note: Data are not comparable across countries.

The share of nonperforming credit in total credit was at about 2% to 3% in most countries at mid-2008. Only in Poland and Romania were the shares significantly higher according to these countries' classification methods. Against mid-2007, however, the share dropped sharply in Poland, while Romania recorded a sharp increase. Interestingly, the share of nonperforming loans did not rise in Hungary despite stagnant economic growth. In countries with robust credit growth, however, there is a general risk that these shares give an overly positive impression of portfolio quality.

Nonperforming Credit

	2003	2004	2005	2006	2007	H1 07	H1 08
	% of total credit						
Slovenia	6.5	5.5	4.8	4.2	3.2	. .	. .
Slovakia	9.1	7.0	3.7	3.3	2.8	3.1	2.9
Czech Republic	4.8	4.0	3.9	3.7	2.8	3.1	2.8
Poland[1]	21.2	14.7	11.0	7.3	5.2	6.3	4.8
Hungary	2.7	2.7	2.5	2.5	2.4	2.5	2.5
Bulgaria	4.2	3.6	2.8	2.2	2.0	2.2	2.5
Romania	8.3	8.1	8.3	7.9	9.7	7.9	10.3
Croatia	5.1	4.6	4.0	3.2	3.1	3.3	3.2

Source: National central banks, OeNB.

[1] Data comprise both nonperforming and so-called irregular credit.

Note: Data are not comparable across countries.

Financial Market Crisis Drives Up Capital Requirements

The international financial market crisis has brought banks' capital ratios into sharp focus as they are an important gauge of banks' risk-bearing capacity. In particular, the capital (adequacy) ratio and the tier 1 capital ratio[36] serve as indicators of a bank's capital adequacy by relating the bank's entire capital and tier 1 capital, respectively, to risk-weighted assets.

At the end of June 2008, the aggregate consolidated capital ratio of all

[36] *For definitions of the capital (adequacy) ratio and the tier 1 capital ratio, see the note on table A23 in the Annex of Tables.*

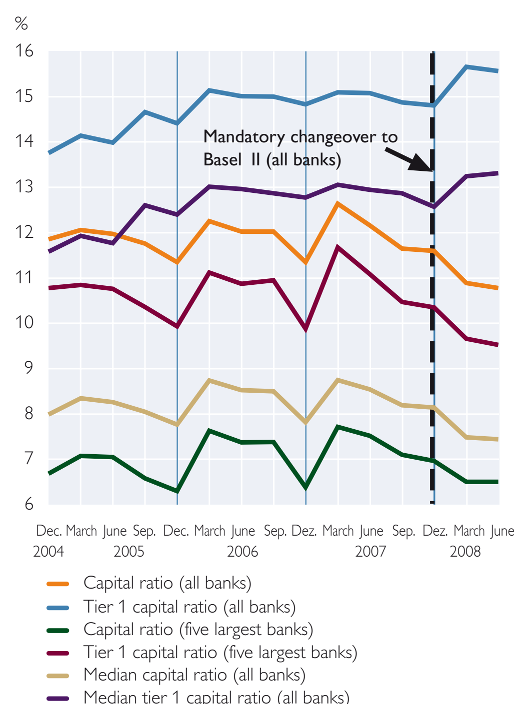
Austrian banks came to some 10.8% (see chart 21), down 1.4 percentage points from the year-earlier figure but still clearly above the minimum capital requirement of 8%. In the first half of 2008, no Austrian bank failed to comply with this minimum level of capital. In particular, the capital ratio did not increase in the first quarter of 2008 compared with its year-end 2007 level, a trend observable in previous years owing to the booking of profits. The decline of the capital ratio in the first half of 2008 is not attributable to shrinking revenues in 2007, but, among other things, to the Basel II regulatory capital requirements that took effect in Austria in January 2008.[37] The new capital requirement for operational risk introduced under Basel II totaled about EUR 3.6 billion, leading to a decrease in the capital ratio. The other capital requirements introduced under Basel II did not have a significant impact on the aggregate capital ratio. The capital requirement for market risk or for the position risk of debt instruments and equities, which had already existed under Basel I, amounted to around EUR 1.8 billion at end-June 2008 and, like in previous years, was covered largely by tier 3 capital. The transition to Basel II also had an effect on the aggregate consolidated tier 1 capital ratio, which contracted from 8.5% in June 2007 to 7.4% in June 2008.

The Basel II-induced decline in the capital ratio during the first half of 2008 was even more pronounced for Austria's largest banks. Year on year, their capital ratio dropped by 1.6 percentage points, coming to 9.5% at end-June 2008 (tier 1 capital ratio: 6.5%). However, the tier 1 capital held by the five largest banks had risen by 6.5% during the same period and came to EUR 28.7 billion at the end of June 2008.

In terms of capital adequacy, smaller Austrian banks tended to benefit from the changeover to the Basel II framework. Their median capital and tier 1 capital ratios each increased by around 0.5 percentage points year on year, reaching 15.6% and 13.3%, respectively, at end-June 2008. This can be attributed to the fact that the capital requirement for credit risk was reduced for smaller banks under Basel II, and this decrease was not entirely offset by the new requirement for operational

Chart 21

Austrian Banks' Consolidated Capital and Tier 1 Capital Ratios



Source: OeNB.

[37] *The Basel II regulatory capital requirements were introduced in Austria on January 1, 2007, but pursuant to Article 103e no. 16 Austrian Banking Act, banks were allowed to calculate their capital charges in 2007 either according to the Basel I provisions or according to the Standardised Approach under Basel II (Article 22a Austrian Banking Act). Since the beginning of 2008, all Austrian banks have had to comply with the Basel II capital requirements.*

risk. Specifically, under the Basel II Standardised Approach, corporate loans are now risk weighted at 75% (if not mortgage backed) or at 35% (if mortgage backed), while they previously had to be risk weighted at 100% and 50%, respectively.

The capital ratios of Austrian banks were still quite satisfactory in mid-2008, and any fluctuations in the ratios were primarily attributable to the application of the Basel II regime. However, market expectations regarding banks' capital adequacy have since been considerably revised upward due to the financial market turbulence. Furthermore, banks might no longer be able to rely – at least not to the same extent – on their excellent profitability performance, which had had a positive effect on their capital ratios in the past. Against this backdrop, banks with – by international standards – poorer capital ratios may be expected to take measures to shore up investor confidence. The measures adopted by the Austrian federal government in October 2008 (see box 5) are sure to support these efforts. In the event of a loss of confidence in the Austrian banking system, they will provide a basis for further timely action.

Box 5

Government Adopts Package of Measures to Strengthen the Interbank Market and to Safeguard Financial Stability

The financial crisis had deepened considerably by mid-September 2008, affecting not only U.S. institutions, but also European banks to an increasing extent. In light of the action plans and rescue measures being adopted at the national, European and international level, on October 20, 2008, the Austrian parliament likewise adopted a package of measures aimed at strengthening the Austrian financial marketplace in a move to mitigate the fallout of the crisis. Specifically, up to EUR 100 billion was earmarked for this package and may be drawn on if necessary to counteract any unfavorable repercussions of the financial crisis on Austrian financial enterprises and to bolster customer and creditor confidence. In addition, a number of measures may be used preventively as "inoculations."

The new provisions (Federal Law Gazette 2008/136) basically rest on two new acts, namely the Interbankmarktstärkungsgesetz (IBSG; interbank market support act) and the Finanzmarktstabilitätsgesetz (FinStaG; financial stability act), as well as on amendments to the ÖIAG[1] Act and to material financial market-related legislation.

The IBSG is meant to revitalize the interbank market, which has been crippled by banks' mutual lack of confidence. The act will remain in effect until the end of 2009. Under this act, banks holding an Austrian banking license (possibly also Austrian insurance corporations) may set up a separate company to act as a "clearinghouse" for which the federal government may assume liability and which may borrow interbank funds to be subsequently lent to other banks (and possibly also insurance corporations). For funding purposes, the clearinghouse may for instance issue securities, which the federal government may again back with a state guarantee. Furthermore, in order to improve medium-term financing conditions in particular, the federal government may also assume liability for bank-issued securities with a maturity of up to five years. The measures envisaged by the IBSG total some EUR 75 billion.

The FinStaG enables the Federal Minister of Finance, partly upon approval by the Federal Chancellor, to use a number of instruments for the recapitalization (defined broadly) of banks and domestic insurance corporations. This measure is worth EUR 15 billion and may be increased provided the EUR 75 billion envisaged under the IBSG have not been fully drawn on.

[1] ÖIAG: Österreichische Industrieholding Aktiengesellschaft (OIAG, the Austrian state holding company).

The instruments are as follows:

- *Issue guarantees for the liabilities of an institution or for an institution's liabilities to public entities,*
- *extend loans,*
- *strengthen the capital base of banks,*
- *Acquire shares/convertible bonds in connection with capital increases or via a legal transaction,*
- *take over a company's net assets.*

If these instruments prove to be insufficient or if they may not be used at all or not in a timely fashion, the Federal Minister of Finance together with the Federal Chancellor may furthermore, under certain conditions, temporarily take over the property rights of a bank – following adequate compensation of the shareholders. To this end, the federal government may involve the ÖIAG or a subsidiary to be set up by the ÖIAG. The Financial Market Authority FMA is obliged to inform the Federal Minister of Finance of circumstances that may indicate a need for action in line with this act.

Based on a legal authorization, the Federal Minister of Finance in agreement with the Federal Chancellor issued a regulation on the general conditions for providing funds in connection with the measures set forth in the two acts. Apart from requiring a charge in line with general market practice, these conditions comprise in particular terms relating to the sustainability of business policies, use of funds, remuneration systems, capital ratios, distribution of profits, preservation of jobs, prevention of competitive distortions and disclosure obligations.

Following the example of other EU Member States, the Austrian government furthermore raised its deposit guarantee in order to shore up public confidence. For deposits held by natural persons, the EUR 20,000 cap on the deposit guarantee was lifted retroactively to October 1, 2008, and now provides unlimited coverage; as of 2010, the deposit guarantee scheme will cover a maximum amount of EUR 100,000. Deposits held by legal persons are still covered up to a level of EUR 20,000 (maximum retention: 10%), while the cap applicable to deposits held by partnerships or corporations that meet specific size criteria was increased to EUR 50,000. The funding of the deposit guarantee scheme was also partly amended.

The measures also authorize the FMA to prohibit or curtail short-selling for a limited period of time. In addition, the scope of action for supervisors was extended with regard to prescribing capital add-ons as a precautionary measure under the Supervisory Review Process (Pillar 2 of the Basel II framework) should they deem this necessary from a risk control perspective.

It is also worth mentioning that the Austrian package of measures is closely aligned with the "Declaration on a concerted European action plan of the euro area countries," which was also endorsed by the European Council. In this respect, the measures were designed to promote both stability and a level playing field.

The Oesterreichische Clearingbank AG (OeCAG), the clearinghouse established pursuant to the IBSG, started operations in mid-November 2008. Furthermore, several banks have already expressed interest in availing themselves of FinStaG-based measures to strengthen their capital base. A stock corporation for financial market investments of the Federal Republic of Austria, the Finanzmarktbeteiligung Aktiengesellschaft des Bundes (FIMBAG), was founded in November to implement such measures and to manage the resulting participations.

Ratings of Largest Austrian Banks Remain Unchanged for the Time Being

Market indicators such as the development of stock prices and ratings can be used to complement supervisory reporting in the assessment of a bank's risk profile. For this purpose, long-term deposit ratings and especially Moody's Bank Financial Strength Ratings (BFSRs) prove particularly useful.

Table 8

Ratings of Selected Austrian Banks

As at November 13, 2008

	Deposit rating		Bank Financial Strength Rating	
	Long-term	Outlook		Outlook
Bank Austria	Aa2	stable	C+	stable
BAWAG P.S.K.	Baa1	stable	D	stable
Erste Bank	Aa3	stable	C	stable
HGAA	A2	negative	D−	positive
ÖVAG	Aa3	stable	C	stable
RZB	Aa2	stable	C	stable

Source: Moody's Investors Service.

The recent developments in international financial markets did not impact Moody's ratings of Austria's largest banks until October 2008 (see table 8). However, in early November 2008, the nationalization of Kommunalkredit resulted in a downgrading. While Fitch changed the outlook on the former ÖVAG subsidiary to positive, that of the parent company was changed to negative. Moreover, Moody's changed the outlook on the Hypo Group Alpe Adria, (HGAA) long-term deposit rating from "under review" to negative. The rating agency stated that it wanted to wait and see how any state aid, the probability of which it had already factored into the rating on the positive side, actually turns out. The Standard & Poor's ratings of Austria's largest banks remained unchanged for the time being; however, the outlook on Erste Bank and RZB was revised downward in light of their CESEE business and the gloomy economic outlook for this region.

Stocks of Major Austrian Banks under Pressure

Stocks issued by banks underwent a period of extreme volatility in the midst of market uncertainty. As a case in point, Erste Bank and Raiffeisen International Bank-Holding AG, the two stocks listed in the ATX Prime index, saw marked setbacks as bank-issued securities had come under pressure worldwide. Concerted action conceived at the European level and implemented at the national level served to instill new confidence in bank stocks from mid-October onward.

The Dow Jones EURO STOXX Banks index,[38] Erste Bank, Raiffeisen International and the ATX index have lost an average of 0.17%, 0.16%, 0.28% and 0.6% (respectively) per day since the outbreak of the financial crisis (see chart 22). In an early phase, when the label "high risk" was still primarily assigned to U.S. subprime loans and credit derivatives, the value of European bank securities plunged by around 35% amid market uncertainty about the banks' actual exposure (Dow Jones EURO STOXX Banks index). Austrian banks were likewise hit by the first wave of waning confidence, even though their subprime exposure was relatively low. At that point in time, investors did not yet fully consider the

[38] *The Dow Jones EURO STOXX Banks index, which is a weighted index of bank shares, includes 39 European banks (e.g. Erste Bank, Raiffeisen International and UniCredit).*

Chart 22

Price Development of Austrian Banks' Stocks

Source: OeNB, Bloomberg.

impact the financial crisis would have on the real economy (ATX performance). The first culmination – when Bear Stearns was sold to JPMorgan Chase in an emergency bailout under the auspices of the Federal Reserve – was followed by a brief respite from April to end-May 2008, during which the stock prices of the two banks listed in the ATX Prime segment as well as the index itself registered gains. In mid-2008, fears about a downturn in the real economy started to materialize. As an increasing number of banks in continental Europe were hit by the crisis in September 2008, the downward trend began to pick up speed. Eventually, the outlook for CESEE, an important market for many businesses listed in the ATX, also deteriorated, not least due to the problems observed in Iceland. In October, panic selling swept markets worldwide, a development which was somewhat exacerbated by portfolio stop loss rules and precipitated record losses on both the Austrian and international stock exchanges.

The spreads on credit default swaps (CDS) of the two Austrian banks in the ATX Prime index showed similarly volatile developments. At around 220 basis points, the current CDS spreads (as at mid-November 2008) exceed the level registered in March 2008.[39] Similar trends are evident in the European banking sector. The development of the implied volatilities of at-the-money call options on these two Austrian bank stocks is also indicative of the financial crisis. Their short-term rise points to further and even more pronounced movements in stock prices.

Financial Turmoil also Has Repercussions on Other Financial Intermediaries

Outlook for the Insurance Sector Clouds Over

The European insurance sector posted weaker overall growth in the first half of 2008, a development which may be traced above all to lower investment results in the wake of the financial market turmoil. The underwriting

[39] *In this context, it is important to add that the informative value of CDS spreads is limited for these two banks because the market is thin and price setting is thus based on low volumes. At the same time, even though smaller changes in the spreads must therefore be interpreted with caution, a trend is clearly discernible for 2008.*

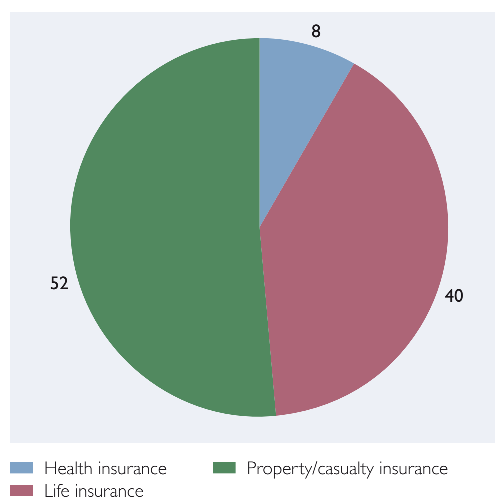
business was influenced by fairly favorable developments of loss events and added substantially to the satisfactory performance of the insurance sector. The deteriorating outlook for the real economy and the large stock price swings, however, contributed to weaker demand in particular for unit-linked life insurance plans and to slower growth of the property/casualty segments. The European insurance sector's risk-bearing capacity appears to have remained adequate, and its exposure to the U.S. subprime market and to structured credit products is essentially limited and for the most part carries the highest ratings. In general, writedowns were far lower in the European insurance sector than in the banking sector. However, insurance companies that draw up IFRS-compliant financial statements and that have so far recognized revaluation losses in equity will post these losses to their income statements after 6 to 12 months, which is likely to occur in the second half of 2008 and which may dampen profitability.[40] At the global level, though, some insurance companies – mainly companies outside the European Union – were compelled to take massive writedowns of their structured credit portfolio. U.S. bond and credit insurers, who guarantee the creditworthiness of structured credit products, were most severely affected.

Chart 23

Breakdown of Austrian Insurance Companies' Premium Income by Segments

As at the fourth quarter of 2007

Share in %



Source: FMA.

In 2007, the total assets of Austria's insurance sector expanded by just under 7%. Aggregate assets amounted to EUR 87 billion in the fourth quarter of 2007 and were equivalent to 32.4% of Austria's GDP.

Austrian insurance premium income ran to EUR 17.9 billion at the end of 2007, with EUR 7.2 billion attributable to the life insurance segment, EUR 9.2 billion to the property/casualty insurance segment and EUR 1.5 billion to the health insurance segment.

Premium income growth stagnated in 2007, falling by 0.05% in real terms[41] and declining in the life insurance segment. Conversely, in the first two quarters of 2008, the life insurance segment – in particular index-linked life insurance – posted a rise in single premiums whereas premiums dropped in real terms in the property/casualty segment.

[40] *Moody's Report: European Insurers' H1 2008 Results. August 2008.*

[41] *Adjusted for inflation.*

Table 9

Key Indicators for the Austrian Insurance Sector in 2006 and 2007

	Real premium growth		Combined ratio		Claims ratio		Cost ratio		Net interest		Solvency ratio
	2006	2007	2006	2007	2006	2007	2006	2007	2006	2007	2007
	%										
Total	0.03	−0.05	104.4	105.2	69.41	68.40	26.14	27.01	5.68	4.98	261.39
Life insurance	−0.65	−1.53	×	×	×	×	16.35	15.86	5.35	4.75	163.47
Property/casualty insurance	0.38	0.98	108.8	109.9	68.76	67.64	40.02	42.29	7.27	6.34	439.79
Health insurance	1.26	0.97	86.4	85.7	72.09	71.55	14.33	14.01	4.14	3.07	394.15

Source: FMA, OeNB calculations.

Note: As life insurance claim payments fluctuated considerably, partly due to external factors, an analysis of the combined ratio and the claims ratio on the basis of just two data points does not provide a meaningful result. For the sake of consistency, the row "Total" shows only non-life insurance combined ratios and claims ratios.

The combined ratio shows the sum of operating expenses and claims payments in relation to the premiums earned in property and casualty insurance. This ratio provides an insight into the profitability of the underwriting business. In other words, if the ratio exceeds 100%, it indicates a loss in underwriting operations. In such a case, a profit on business other than underwriting, in particular on investment results, can offset or reduce such losses. In 2007, the combined ratio expanded marginally to roughly 110%, which was traceable to a rise in the cost of concluding insurance contracts. In an environment of higher volatility and unfavorable financial market developments, investment results contribute less to the profitability of property/casualty insurance.

The claims ratio depicts expenditure on claims as a percentage of total premiums[42] and reflects an insurance company's ability, throughout the insurance cycle, to assume risk at an appropriate price. In 2007, the claims ratio in the property/casualty segment dipped by 1 percentage point to 67.7% of premium income. However, in the first two quarters of 2008, claims payments in the property/casualty segment widened more strongly than premiums.

Investment profitability[43] diminished by 0.7 percentage points to just under 5% in 2007. This result reflects the favorable macroeconomic environment of the first half of 2007 and the U.S. subprime crisis of the summer of that year. In 2008, investment results continued to decline noticeably in the first two quarters as a consequence of persistently strong financial market volatility.

Austrian insurance companies' provisions to cover and meet the claims of insurance holders ran to EUR 70.6 billion.[44] At the end of June 2008, insurances companies had invested just under 12% of their cover reserves and cover assets in stocks, 49% in debt securities and 17% in investment funds. A large part of the debt securities were corporate and bank bonds, whose credit and liquidity risk is higher than that of government bonds.

[42] *Adjusted for the reinsurance share in each case.*

[43] *Ratio of the net investment result to average investment in the respective calendar year.*

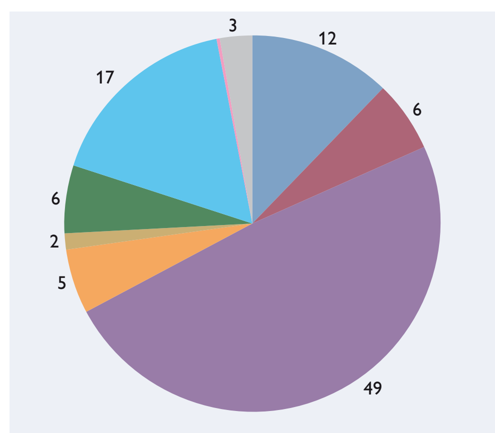
[44] *Exclusive of unit- and index-linked life insurance policies.*

Chart 24

Investment of Austrian Insurance Companies' Cover Reserves and Cover Assets

As at end-June 2008

%



Stocks and equity-like securities
Real estate funds
Debt securities
Loans and advance payments on insurance policies
Hedge fund shares
Balances held with credit institutions
Mutual fund shares (fixed-income funds)
Holdings of derivatives
Other assets

Source: FMA.

Only minor changes in insurance companies' investment strategies could be observed in the first two quarters of 2008. The weight of stocks in the investment portfolio dropped marginally, but this may be traced for the most part to the relative value change of insurance companies' portfolios.

Insurance companies' capital ratio provides information about their risk-bearing capacity. A look at the solvency ratio – available capital (own funds) as a share of the regulatory capital requirement – indicates that the Austrian insurance industry is adequately capitalized. The solvency ratio has risen markedly since 2003 and is highest for insurers in the property/casualty segment. Austrian insurance companies' capital ran to roughly EUR 7.5 billion at end-2007, with the share of capital in total assets having increased by 1 percentage point to 8.6% in 2007.

Market indicators for both the European and the Austrian insurance sectors reflect higher uncertainty, which is attributable to the financial turmoil on the one hand and to potentially weaker income dynamics on the other. Developments surrounding several U.S. and European financial institutions triggered price losses even of insurance companies' stocks. However, performance varied widely among insurance companies, depending – inter alia – on their diversification, income structure, regional focus and on the size and transparency of their structured credit portfolios. The stock prices of insurance companies listed on the prime market segment of Wiener Börse AG took a beating between May 2008 and mid-November 2008.

Investment at Banks Augments Again

Year on year, Austrian insurance companies' total exposure to domestic banks jumped by 35% to EUR 14.9 billion (15.1% of total assets of the Austrian insurance industry) in the second quarter of 2008. Cash held with domestic credit institutions rose especially strongly. Overnight deposits and longer-term balances with Austrian banks doubled to EUR 4.2 billion, among other things as a result of developments in the financial markets. Debt securities issued by domestic banks accounted for the bulk of the remaining exposures, which had climbed by 4.2% to EUR 9 billion. Year on year, loans to domestic banks rose by 30% to just under EUR 0.7 billion. Insurance companies' investments with domestic credit institutions thus grew to slightly more than 1.4% of Austrian banks' consolidated total assets.

For both the European and the Austrian insurance sector, lower investment results in the wake of more pronounced insecurity on financial markets may continue to weigh on insurance company profitability. Moreover, an unfavorable development of loss events as well as an underestimation of longevity risk may reduce insurance companies' risk-bearing capacity. A more risk-adequate pricing of assumed risks may help to reduce these risks, but competition in some insurance segments is relatively high. Against this background and given the weakening real economy, the outlook for European and Austrian insurance companies has deteriorated.

Mutual Funds Record Ongoing Outflows

In the period under observation, the development of the European mutual fund market was characterized by heightened uncertainty among investors and by high volatility on the financial markets. Assets under management by European mutual funds[45] contracted by 8.0% to EUR 7,280 billion in the first half of 2008 and by 11.6% year on year. In the second quarter of 2008, mutual funds registered net outflows for the fourth quarter in a row. Even money market funds, whose strategy focuses on capital preservation, suffered net outflows in the second quarter of 2008. Only balanced funds succeeded in netting slight inflows. Against the backdrop of higher financial stability risks in Europe and investors' reduced risk appetite, the outlook for the European mutual funds sector remains uncertain.

Domestic Investment Becomes More Important for Austrian Mutual Funds

The Austrian mutual funds sector continued to post a weak overall performance in the first six months of 2008. Assets under management by Austrian mutual funds (including fund-of-fund investments) fell by 14.6% year on year – or by 10.1% from the beginning of 2008 – to EUR 148.9 billion. The reassessment of credit risk and higher inflation caused stock prices to slump and the price of debt securities to decline, entailing price losses, lower dividends and net outflows from mutual funds. This development benefited bank deposits, as investors' interest in such investment has been rekindled since the outbreak of financial turbulence in the summer of 2007. Since June 2007, mutual funds have reduced their foreign positions (–17.1%) to a greater extent than their domestic positions (–9.8%), which may be seen as an indicator that mutual funds tend to opt for domestic over foreign investment in an environment of greater uncertainty. Mutual funds reduced their holdings of foreign equity securities (–37%) most strongly. Conversely, the share of domestic equity securities even rose marginally by 2.4% in the first half of 2008. Both domestic and foreign real estate and tangible assets expanded powerfully (by 36% and 43%, respectively), but their combined share in total assets came to only about 1.3%. The capital-weighted average total performance of all Austrian mutual funds stood at –5.3% in the first half of 2008. Equity funds performed worst, with their value contracting by 20.1%, and balanced funds

[45] *Here, mutual funds comprise undertakings for collective investment in transferable securities (UCITS) and non-UCITS.*

lost 5.8%. Money market funds and fixed-income funds (just under –0.4% and –0.5%, respectively) did not succeed in posting a positive performance, either. Only real estate funds registered gains, a development traceable to the minor role of listed assets in their portfolios.

With credit markets drying up further and stock exchanges being shut down, above all in Russia, some mutual funds temporarily suspended the redemption of shares on the grounds that some assets could not be valued. According to the Austrian Financial Market Authority FMA, the trading of shares of 16 of the total of about 8,300 (domestic and foreign) mutual funds registered for operation in Austria was temporarily suspended; 6 of these funds had been set up by Austrian investment companies.

The direct risk investment companies pose for Austrian banks is limited, however, and consists mainly of a possible future worsening of their profitability. The business and profit performance of Austrian investment companies, which are largely owned by Austrian banks, reflected the difficult business environment for mutual funds in the first half of 2008. As a result of the 15.1% drop in fee-based income following the fall in sales of shares and lower asset values, operating income went down by 13.9% to EUR 179.6 million. At the same time, operating expenses rose by 7%, so operating profit plunged by 30.6% to EUR 80.4 million.

Pension Fund Performance Affected by Financial Market Turbulence

In the second quarter of 2008, 6 multi-employer and 13 single-employer occupational pension funds were operating in Austria. The aggregated total assets of investment and risk-sharing groups diminished to EUR 12.6 billion in the second quarter of 2008 from EUR 13 billion in the second quarter of 2007. Pension funds outsourced the bulk of investment. About 91.1% of pension funds' assets were held in the form of mutual fund shares. The share of foreign currency investment decreased to 3.7% from 4.6% in the second quarter of 2007. At the end of 2007, there were 484,359 prospective beneficiaries and 58,471 beneficiaries. Roughly 84% of all (prospective and retired) beneficiaries were assigned to a defined contribution system, while the remaining 16% were assigned to a defined benefit system.[46] About 27.4% of aggregate premium reserves are backed by a minimum return guarantee, and about 4.9 percentage points of these 27.4% are additionally partly secured by employers' obligation to make unlimited supplementary contributions.[47] While there is no minimum return guarantee for 72.6% of aggregate premium reserves, 21.6 percentage points thereof are partly secured by employers' obligation to make supplementary contributions.

The remuneration for covering operating expenses, which is borne by the beneficiaries, came to around EUR 64.3 million and has thus remained

[46] *Source: Fachverband der Pensionskassen (Austrian occupational pension fund association).*

[47] *Source: Aggregated balance sheet of Austrian pension funds (according to FMA data).*

practically unchanged against the previous year.[48] This figure corresponds to 27.7% of the investment result of investment and risk-sharing groups (EUR 231.9 million), to 8% of contributions (EUR 807.2 million) and to 0.5% of assets (EUR 12.6 billion). Income on ordinary activities ran to EUR 30.7 million, translating into a return on equity (ROE) before taxes of 16.5%.[49]

Pension funds' asset allocation breakdown has changed in the wake of the financial turmoil that started in August 2007: Investment in euro bonds (including cash and loans) advanced from 55% in the second quarter of 2007 to 65.1% in the third quarter of 2008, investment in euro area stocks sank from 25% to 19% and investment in other stocks declined from 16.8% to 12.6%. The shares of non-euro-denominated bonds (1.3%) and of real estate (2% compared to 1.8%) were adjusted only minimally. This shift in asset allocation may be traceable to relative price changes, but also to a change in pension funds' investment strategy. From January through September 2008, their average return on investment[50] came to –8.40% (in nominal terms).[51] From December 31, 1997, (when the Oesterreichische Kontrollbank, OeKB, started to calculate return on investment) up to the third quarter of 2008, i.e. over a period of more than ten years, multi-employer occupational pension funds achieved a nominal return on investment of 3.38% per annum and single-employer occupational pension funds one of 4.21% per annum.[52]

[48] *Source: Aggregated balance sheet of Austrian pension funds (according to FMA data).*

[49] *Equity is defined as in the Federal Act on the Establishment, Administration and Supervision of Pensionskassen, Annex 1, Form A, liabilities, item A. If equity is adjusted for the minimum yield reserve (which is not provided by stockholders, but by prospective and retired beneficiaries), ROE comes to 22.3%. If income on ordinary activities is adjusted for transfers to the minimum yield reserve (this reserve accrues to stockholders only if the minimum return guarantee does not become effective), ROE comes to 13.7%.*

[50] *Unfortunately, the Austrian occupational pension fund association has discontinued publication of pension funds' performance data on its website (www.pensionskassen.at).*

[51] *Source: Oesterreichische Kontrollbank. Inflation as measured by the Harmonised Consumer Price Index (HICP) came to about 2.2% in Austria from January through September 2008.*

[52] *A comparable investment not subject to investment income tax would have had to yield 4.5% or 5.6% per annum to match the performance of multi-employer and single-employer occupational pension funds, respectively. Between 2000 and 2008, pension payments fell between 25% (investment and risk sharing groups with a discount rate of 6.5%) and 15% in nominal terms (investment and risk sharing groups with a discount rate of 5%), which equals a decline in real terms by 35% and 25% respectively (according to data provided at the information day of the Austrian pensioners association (Österreichischer Seniorenrat) on June 30, 2008, and OeNB. 2008. Statistiken Daten & Analysen Q4/08). Pensions funds are planning to cut pension payments by an average 12% in nominal terms in 2009 (source: Austrian occupational pension fund association).*